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UNCLAS SECTION 01 OF 03 MANILA 000108

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TREASURY FOR OASIA

E.O. 12958: N/A
TAGS: EFIN ECON ECIN RP CN XE XD
SUBJECT: Financial Crisis Impact on Assistance to the Philippines

REFS: A) State 134905, B) Manila 2740, C) Manila 2725,
D) Manila 2532

¶1. (SBU) Summary: The global financial crisis has caused asset values to decline and unemployment to increase and will slow Philippine GDP growth; but record high foreign reserves, less reliance on international trade, banking sector reforms, and the government's improved fiscal position leave the country in a much better position to weather the crisis than many of its neighbors, as we reported in detail in refs B and C. In the paragraphs below we respond to the questions posed in ref A regarding the impact of the crisis. End Summary.

## Are Key Sectors Slowing?

¶2. (U) Philippine Gross Domestic Product (GDP) growth has slowed this year from 2007's 7.2% three-decade high, but still reported 4.6% growth year-on-year through the third quarter. Electronics exports, which account for nearly two-thirds of Philippine merchandise export revenues, dropped by a sharp 18.9% in October and by 17% in November and face grim prospects for 2009. The automobile industry here mustered 5.6% growth (measured in number of units sold) during 2008 but that performance was down from the 14% year-on-year expansion posted during the first eight months of the year, indicating slowing growth since September. Automobile sales in December expanded only 1%. The Philippine government's target to create an important mining sector by 2010 is at risk and domestic mineral production is actually declining, in part due to lower prices. Aside from electronics and mining, real estate is beginning to be affected. The index of listed property firms of the Philippine Stock Exchange is down more than 50% from its highs of just a year ago.

¶3. (U) On the other hand, some sectors of the Philippine economy are still doing quite well. Business process outsourcing remains on track to hit its 40% revenue growth target for 2008. The industry's employee base increased in 2008 by more than 36% to more than 400,000. The impact of the global financial crisis on agriculture will likely be indirect and minimal. In the rural areas and for the microenterprise sector in particular, there has been no reported drop in sales activity. In fact, many microfinance borrowers have reported an increase in business and some have remarked that business has never been better.

## Social Impact and Government Reaction

¶4. (U) The global financial problems come at a time when the Philippines has been making progress on important financial market reforms. In August, President Gloria Macapagal-Arroyo signed the

Personal Equity and Retirement Account Act into law, establishing a regulatory framework and tax incentives for retirement plans to attract savings. President Arroyo also recently signed the Credit Information Systems Act to facilitate access to affordable capital by providing financial institutions access to information on borrowers' credit histories. Foreign business chambers are now pushing even harder for measures to address floundering competitiveness rankings, curb corruption, reduce bureaucratic red tape, and boost public sector spending to blunt the impact of the global crisis on the economy. They note the estimated 40% to 50% of taxes that still escape collection as another area for improvement. During the first week of January, Government officials announced a $6 billion "economic resiliency plan" which includes $2 billion for infrastructure in partnership with government financial institutions and private banks, as well as assistance for returning overseas workers, export sector assistance, and expanding social safety nets -- but provided little detail.

¶5. (U) According to the government's labor force survey the unemployment rate rose to 6.8% from 6.3% in October. Manufacturing employment was especially hard-hit, with an estimated 163,000 jobs lost year-on-year. Uncertain prospects for 2009 threaten domestic job opportunities for the one million or so annual new entrants to the Philippine labor force. Officials from the Employers Confederation of the Philippines fear that if conditions worsen, only 500,000 new jobs will be created while between 200,000 to 250,000 workers risk displacement. This will push more Filipinos into the informal economy and worsen already high poverty rates. The government plans to assist overseas Filipino workers who repatriate after losing their jobs, but it does not anticipate social unrest.



## Impact on Trade, Remittances, and Investment

¶6. (U) As noted above, slowed global demand will have a significant impact on Philippine electronics industry exports and employment in that sector. However, job losses in merchandise export industries will likely be exceeded by new hiring in the business process outsourcing industry. Remittances from overseas Filipinos equal about 11% of Philippine GDP and are the Philippines' largest source of net foreign exchange earnings and by far the largest net contributor to the balance of payments surplus. These remittances continued to grow rapidly in 2008 (15.1% through November) and are projected to show modest growth through 2009 (around 7% according to current government projections) despite the global economic downturn. Some Filipinos working in factories in Singapore and Taiwan have lost their jobs, but many overseas Filipino workers are in industries (health care and other services) less affected by the crisis. Shipping companies that employ large numbers of Filipino seamen report that, despite sharply declining business worldwide, they are reluctant to lay-off their Filipino crews. According to the Philippine Overseas Employment Administration, 450,000 active job orders are waiting to be filled by Filipinos and more are under negotiation.

¶7. (U) Net foreign direct investment flows in the ten months to October 2008 totaled $1.4 billion, down 46.2% from the same period in 2007 as investment decisions were stalled by foreign investors' concerns over the developments in financial markets, particularly in the weeks following the unfolding of the global financial crisis in late September. For example, one major equity sale of a Philippine transportation company to a foreign buyer was reduced from 100% to 49% due to tightened finances. A $2 billion Korean shipbuilding investment in Mindanao is on hold, in part due to the decline in orders for new ships. Investments in semiconductor and mining will likely also fall in response to falling demand in those sectors. Portfolio capital investments posted a net outflow of about $1.4 billion in 2008, with an estimated 85% of that total net outflow occurring during the last four months of the year.

## Impact on Credit and Banking

¶8. (U) Outstanding commercial banking system loans continued to grow robustly year-on-year in October (21.9%) and November (21.3%). Loans and deposits at rural banks reportedly have continued to increase without tighter credit conditions. Recently, however, senior Central Bank officials said that commercial banks have noted slowing demand for credit as well as greater caution and more intense due diligence in extending loans due to strong global recession fears. Banks have expressed greater caution about lending to exporters, high-end real estate developers, and investors. The Central Bank foresees banks' "guardedness" contributing to slower loan growth in 2009 but not a credit crunch. In spite of the increased caution, selectiveness in issuing loans, and tighter lending requirements, automobile and real estate industry executives report that financial institutions continue to compete aggressively for the most credit-worthy borrowers.

¶9. (U) Commercial banks' non-performing loan ratio as of October was under 4%, little changed from the ratio before September. Nonetheless, there are concerns that non-performing loan ratios could rise to 6% or 7% (nowhere near the 18%-19% Asian crisis peak in 1997-98). Recent closures of a number of small, rural banks have made the headlines lately, but these banks make up a very small share of total banking system resources, and their closure was not related to the global financial crisis. Nevertheless, the Central Bank supports legislative initiatives to increase the level of deposit insurance as a mechanism to shore up confidence. Estimated maximum exposure to assets of troubled or bankrupt foreign financial institutions is less than 2% of total assets, far less than in some other Southeast Asian countries. Banking sector reforms, including increasing banks' capital requirements and the adoption of international capital adequacy and financial reporting standards also have improved the Philippine banking industry's resilience to external shocks.

## Impact on Public Spending

¶10. (U) Expecting weaker economic growth, the Philippines abandoned its balanced budget goal and opted for deficit targets equivalent to 1% of GDP in 2008 and 1.2% of GDP in 2009, and plans to frontload spending during the first half of 2009 to spur the economy.



Accordingly, Finance Department officials concede that 2009 will be a challenging year revenue-wise as the government seeks higher collections while facing revenue losses from a scheduled reduction in the corporate income tax rate from 35% to 30% and from a tax relief package for minimum wage and salaried workers that went into effect in July 2008 in response to high food and consumer price inflation. The 2004 passage of a controversial value added tax law improved government finances and helped the country avert a fiscal crisis, but weak tax collection, currently at only 14.5% of GDP, remains a challenge and lags most of the Philippines' Asian neighbors. There are also continuing challenges and weaknesses in infrastructure project implementation and public expenditure management.

¶11. (U) The government successfully raised $1.5 billion from the international bond market on January 7 - achieving its full-year foreign commercial borrowing target at a coupon rate of 8.5%, roughly 30-40 basis points more than what comparable Philippine bonds due in 2019 yielded ahead of this issue. The government seeks another $1 billion from multilateral and bilateral donors, according to Philippine Finance Department and Treasury Bureau officials.

## Actions of Other Organizations

¶12. (U) The Philippines has not requested an International Monetary Fund program. The Asian Development Bank expects higher requirements for budget support than agreed under its Country Operations Business Plan 2009-2010 and will hold discussions in the first quarter of 2009. The Philippines requested assistance from the World Bank to counter the impact of the crisis during the annual meetings last October 2008. The World Bank agreed in December 2008 to a $200 million Development Policy Operation to support the

Philippine Government's efforts to address the challenges of high food prices in the short and long term. These funds will support conditional cash transfers and other social safety nets for vulnerable households. The Philippines has asked assistance from the World Bank and USAID to help determine the risks and potential impacts of the global financial crisis and economic downturn on the Philippines.

## Impact on Assistance Programs

¶13. (U) According to the International Monetary Fund, the widening interest rate spreads between Philippines and U.S.-based debt yields could negatively affect bank profitability in the Philippines. The World Bank's new Country Assistance Strategy notes increased vulnerability to external shocks, changes in investor sentiment, and the possible adverse impact on overseas worker remittances, exports, and foreign direct investments. The European Community delegation in the Philippines is still responding to concerns from the food price crisis of early 2008 rather than the current financial crisis. Australian and Japanese assistance programs are monitoring the situation closely, but have not reported any operational changes due to the global financial crisis.

¶14. (U) Comment: As we reported in refs A and B, the impact of the global financial crisis in the Philippines will probably be significantly less than what is felt in many neighboring economies, and though key sectors may suffer substantial losses, overall the Philippines is still expected to avoid an outright financial crisis or broad, severe economic downturn of its own. Of course, the Philippines would suffer significantly if large numbers of overseas workers lose jobs and remittances decline, or if food prices spike again this year. These possibilities are not likely, but in such a scenario an appropriate shift in the focus of assistance efforts may be warranted. For now, however, we are maintaining our current programs as planned and continue to monitor the situation closely.

Kenney